CENTRIC Wealth

Aspects of Financial Planning

Use of trusts in financial planning

July 2011

The incorporation of a trust structure into one's financial and estate planning may have merit in certain circumstances. This article provides a brief outline of the key features of a trust and examines the advantages and disadvantages of using trust structures in the context of financial planning.

Background

A trust can be described as a fiduciary obligation imposed on a person, the trustee, to hold property or income for a particular purpose, or for the benefit of other persons (i.e. beneficiaries). Beneficiaries may include you, your spouse, adult children, minor children, grandchildren, a company and/or another trust.

Although the trustee holds the legal title to property, the trustee is required to deal with it on behalf of the beneficial owners in accordance with the terms of the trust as outlined in the trust deed. Trusts can be used to own and operate a business, hold a family's passive investments (e.g. shares, property) or hold a family's interest in a partnership.

Trusts can be classified broadly into either 'fixed trusts' or 'discretionary trusts'.

A fixed trust (e.g. a unit trust) specifically allocates all capital and income generated by the trust to the beneficiaries according to the provisions outlined in the trust deed. The trustee has no discretion to vary the distributions; each beneficiary has a fixed entitlement to either income or capital of the trust or a combination of both.

The type of trust most commonly used is a discretionary trust. In such a trust, the trustees of the trust have discretion granted in the trust deed to distribute capital and income generated within the trust to the beneficiaries in proportions that can vary from year to year. This allows trustees to have maximum flexibility in dealing with the trust distributions.

Most family trusts are discretionary trusts. For specific information on Testamentary Trusts please see our Aspect with this title.

Trusts can be very complex and therefore we recommend you seek professional advice from an accountant or lawyer who specialises in this area in conjunction with your financial planner in determining the most suitable trust structure for you.

Three main advantages of trusts

1. Income splitting

By using a properly drafted discretionary trust, distributions can be made to the most appropriate members of the trust in terms of their tax status or other criterion. In this way, discretionary trusts can be effective in reducing the overall taxation liability of a family. For example, more income may be distributed to beneficiaries in lower tax brackets or those with no other income to utilise their $6,000 tax free threshold, and potentially the low income tax offset; capital gains may be distributed to a beneficiary who has capital losses available or who can utilise the 50% general discount; and franked dividends may be paid to a beneficiary who can use the imputation credits to eliminate or reduce tax on other income.

Only a small amount of income can be distributed to minor children (i.e. children under age 18) tax efficiently, as penalty rates of tax apply to taxable income above $417.

Conversely, children over 18 who are not yet earning at a high level (eg university students), disabled children, or orphaned children can still receive substantial income distributions tax efficiently and use the Low Income Tax Offset. For minor children this equates to having a tax free taxable income of up to $3,333 taking into account the child's penalty tax rates and the Low Income Tax Offset.

Whilst trusts may provide a number of tax benefits, you must always be cognisant of the anti-avoidance provisions of the Tax Act (Part IVA) which may apply in circumstances where the dominant purpose for entering an arrangement or scheme is to derive a tax benefit.

2. Asset protection

Many clients are concerned about protecting their assets, however it is important to realise that only some assets are protected in a trust. Assets owned by a trust are generally not accessible

by your personal or business creditors, assuming the trust does not carry on the business. This may be of particular interest if you own a separate business or are a professional or senior executive within a company. People in these positions can find themselves personally exposed in any number of situations such as financial difficulties, borrowings and professional or public liability claims in or against the business.

Your personal assets can be separated from your business creditors and business risks if held in a separate trust. The significant advantage of a discretionary trust is that the assets are owned by one person(s), the trustee, and the benefit of the income and capital of the trust passes to another person/s, the beneficiaries. This separation of ownership/control and benefit allows trusts to protect assets from any legal action involving the beneficiaries and/or misuse of those assets.

To achieve this asset protection, you must gift the capital to the trust. If you lend money to the trust you still own an asset, the loan, which can be accessed by creditors etc. Gifts of assets other than cash are likely to be inappropriate as they may attract both stamp duty and capital gains tax.

If you transfer your family home into the trust it will no longer qualify for the capital gains tax exemption as your principal residence and it will be subject to stamp duty on transfer and ongoing land tax. This may still be appropriate if asset protection is of primary concern.

Some clients may see the use of trusts as a means of protecting assets in the case of bankruptcy. It is important to note that under bankruptcy legislation, the bankruptcy trustee has a range of powers to enable the recovery of assets in certain circumstances. This may occur where assets have been given away or sold at less than market value or when gifts have been made to the trust within five years of an individual becoming bankrupt.

3. Estate planning

The trust survives your death as the assets are not yours and continue to be held for the beneficiaries via the trust. This can have capital gains tax advantages if correctly incorporated into an estate plan. Similarly with asset protection above, only assets that are gifted and not loaned to the trust will remain within the trust. A loan made by a beneficiary to the trust forms part of their estate upon their death.

In certain circumstances, a trust can be specifically tailored to ensure that the principal's assets stay within their family or their direct lineal descendants for a period of up to 80 years, generally the maximum perpetuity period in most states. This may be particularly useful for families experiencing a marriage breakdown or divorce. Properly drafted, a discretionary trust can result

in assets being excluded from property settlements on marital divorce or breakdown in a de facto relationship.

Disadvantages of a trust

Separate entity

A trust is a separate entity to you personally and it is important that you keep your affairs and those of the trust totally discrete. You must retain a separate bank account and some form of accounting records for the trust and all decisions made by the trustee, for example payments to beneficiaries must be properly documented. Thus there is some increased administration not present when owning your assets personally.

Costs

The set up of a trust involves initial costs; including fees payable to the specialists who advise on setting up the trust, Government stamp duty, registration fees and the cost of establishing a corporate trustee. In addition, ongoing costs are involved to cover specialist advice received in completing the trust tax return and other records which must be lodged annually. The following table provides an estimate of the initial and ongoing costs to establish and maintain a trust structure.

Initial costs	
Establishing trust and drafting trust deed	$500
Stamp duty and registration fees	$200
Establishing a corporate trustee	$700
Ongoing costs	
Accountant's fees to prepare annual tax return and ASIC return for the corporate trustee	$1,500
Annual ASIC lodgement fee	$212
Trust deed amendments (when required)	$500

Please Note: The above table provides a guide only. Centric Wealth has no control over the fees that may be charged by other specialists; however a portfolio of the type recommended by Centric Wealth should result in fees of this order. Where one's financial affairs are more complex the costs may be considerably higher. If you decide to pursue the use of a trust, a precise quote should be obtained before you proceed.

Distribution of income

All taxable income earned during the trust's financial year should be distributed to beneficiaries and included in the beneficiaries' taxable income in the same tax year. Any undistributed income is taxed within the trust at the top personal tax rate currently 46.5% including Medicare levy.

Trust losses can not be distributed to beneficiaries. However, under the trust loss measures, a trust may only be able to deduct prior year losses or certain debt deductions in certain circumstances. Further, where a discretionary trust has a nil net income or a net loss it will not be entitled to a refund of excess imputation credits.

Control of assets

As the assets are not yours you cannot control their distribution via your will on death. You cannot gift specific assets held in the trust on your death because they are not yours to give. As an alternative, if a corporate trustee (see below) is used you may gift your allocation of shares and therefore your control of the trust to a chosen beneficiary.

The appointor

The appointor may be a person or persons and is usually one of the primary beneficiaries of the trust. The appointor effectively controls the trust as they, depending on the terms of the trust deed, may appoint or remove the trustee/s. It is for this reason that the succession of the appointor is critical and should be clearly documented in the trust deed.

The trustee

In most cases, the use of a corporate trustee is recommended as a corporate trustee will survive the death or incapacity of an individual. More importantly, a corporate trustee provides better asset protection than an individual trustee.

The trustee company will be set up with one or two directors and shareholders, at your choice, who of course can be you personally. In this way you have direct control over the trust. The share(s) can be included as a specific item in your will and left to a person of your choice who in turn will, by virtue of his or her inherited share holding, nominate, probably themselves, as the new director of the company.

The corporate trustee structure also helps to distance you personally from the liabilities of the trustee.

One disadvantage is the small additional layer of expense in establishing and maintaining the company to act as a trustee. The company must lodge an annual return with the Australian Securities and Investment Commission (ASIC) but no tax return is necessary if the company does nothing other than act as trustee.

Taxation position

Under current law, provided the trust distributes all taxable income earned during the year, it will pay no tax. As outlined above, if income is not distributed, the trust will be taxed at the highest personal rate of tax.

Tax is paid on the trust's income by the beneficiaries who receive it. The nature of the income, as received by the trust, passes through to the recipient. For example franked dividends or tax free income received by the trust retains its status when passed to the beneficiary. Income received is included in the assessable income of the beneficiary and aggregated with other assessable income; tax is then assessed at the beneficiary's marginal rates.

Borrowing by the trust should not be contemplated without first obtaining taxation advice.

If a beneficiary is under legal disability (eg a minor), the trustee is assessed on the share of net income to which the beneficiary is presently entitled. The trustee will be required to pay tax on the beneficiary's behalf. The distribution of the trust's assessable income to a corporate beneficiary will be subject to the corporate tax rate of 30%.

Outcome of Bamford's case

The Bamford's case, involving two taxpayers, Mr and Mrs Bamford, and the Commissioner of Taxation was resolved by the High Court in March 2010. This case examined two phrases of taxation law that address two of the most fundamental aspects of the taxation of trusts.

The outcome of the debate around the first phrase, "share of the income of the trust estate" centred on the definition of 'share' and whether a proportionate or quantum approach should be taken. It was held that, in situations where the net income of the trust exceeds the distributable income, regardless of whether a fixed or proportionate amount is actually distributed to a beneficiary, the proportionate view is the correct method to use in determining who is liable to pay tax.

The second phrase, "net income of the trust estate", questioned whether a trust deed could define what is income and capital in a way which overrides taxation law. The High Court held that the trustee has absolute discretion to treat a net capital gain as income of the trust in accordance with the trust deed. Therefore the terms of the trust prevails in determining what

is meant by 'net income of the trust estate' to which beneficiaries are presently entitled and assessed for tax.

To clarify the outcome of the "Bamford Case" the Government has recently enacted legislation to enable the streaming of capital gains and franked distributions (including any attached franking credits) of a trust to beneficiaries taking affect from 1 July 2010.

Trustees wishing to stream capital gains and franked distributions must make particular beneficiaries "specifically entitled" to those amounts and the trust deed must permit the streaming to occur.

A trust that has not made particular beneficiaries "specifically entitled" to capital gains and franked distributions will generally produce the same outcome as that under the "proportionate approach".

However, the Government has also announced, with the introduction of this measure, that these changes are an "interim measure" and will be reviewed when the relative tax law is rewritten.
It is important that any discussion involving the taxation of trusts considers the above outcomes.

Family trust elections

It is now necessary for trustees to decide whether or not to elect to be treated as a family trust. It is by no means clear that all trusts should make this election as it is generally irrevocable, to all but fixed trusts, and may have adverse consequences many years after the election was made but perhaps quite appropriately at the time. This decision must be taken only on advice from your lawyer and/or accountant.

There are two situations where lodging a family trust election may be beneficial. These are:

1. To avoid having to comply with the rules regarding utilising trust losses, where the trust has carried forward losses from prior years, with the exception of the 'income injection test'; or
2. To ensure imputation credits flow through to beneficiaries of the trust.

The second of these two is the more likely reason for an investment client of Centric Wealth to have to consider a family trust election.

A company, trust or partnership is required to make an interposed entity election if it is to be included as part of the family group specified under the election. A trust which makes a family trust election must only make distributions to a member of that family (as defined), otherwise

the distribution, whether income or capital, will be subject to 'family trust distribution tax' which represents tax payable at the highest marginal tax rate.

Conclusion

Trusts in certain circumstances, can be a beneficial feature when structuring your financial affairs. However there are many issues to discuss with your financial planner and accountant prior to making this decision.

Centric Wealth Advisers Ltd may be able to be of assistance

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Centric Wealth recommends that you obtain financial and tax or accounting advice based on your personal situation before making an investment decision.

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